Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author: Lempert, el. Al.	Analyst: Marion Mann DeJong	Bill Number: AB 1063
Related Bills:	Telephone: (916) 845-6979	Amended Date: 06/11/98
	Attorney: Doug Bramhall	Sponsor:

SUBJECT: Manufacturers' Investment Credit/Qualified Property Includes Computers & Peripheral

____ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended ________.

__X__ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

____ AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended ________.

__X__ FURTHER AMENDMENTS NECESSARY.

____ DEPARTMENT POSITION CHANGED TO ________________.

____ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED/AMENDED __________ STILL APPLIES.

____ OTHER - See comments below.

SUMMARY OF BILL

This bill would add manufacturers of custom or prepackaged computer software (involved in activities described in Standard Industrial Classification (SIC) codes 7371 to 7373) to the Manufacturers' Investment Credit (MIC).

This bill also would provide that a small business involved in specified computer activities (activities described in SIC codes 7371 to 7373) may claim the MIC on that portion of costs which may be allowable to be expensed under Section 179 of the Internal Revenue Code (IRC). However, the taxpayer would be required to reduce the amount of the Section 179 expense deduction by the amount of the credit.

This bill would make changes to the sales tax laws which will not be analyzed as they do not impact the department's programs and operations.

SUMMARY OF AMENDMENT

The June 11, 1998, amendments deleted the provisions declaring the Legislature's intent to expand the MIC to activities relating to computer programming and computer software and inserted language (similar to the April 9, 1997, amendments) to expand the MIC to those activities.

EFFECTIVE DATE

As a tax levy, this bill would become effective immediately upon enactment and would apply to taxable or income years beginning on or after January 1, 1998. Further, the bill would specify that for purposes of the MIC, taxpayers engaged in activities described in SIC codes 7371 to 7373 qualified costs would not

Board Position:			Department Director	Date
__X__ S	____ NA	____ NP		
____ SA	____ O	____ NAR		
____ N	____ OUA	____ PENDING	Gerald H. Goldberg	7/1/98

include costs associated with a binding contract in existence on or prior to January 1, 1998.

LEGISLATIVE HISTORY

SB 671 (Stats. 1993, Ch. 881); SB 676 (Stats. 1994, Ch. 748); AB 2661 (1995/96); SB 38 (Stats. 1996, Ch 954.); SB 1106 (Stats. 1997, Ch. 604); AB 2441 (1997/98).

SPECIFIC FINDINGS

Existing state and federal laws generally allow a depreciation deduction for the obsolescence or wear and tear of property used in a business or investment property. The property must have a limited, useful life of more than one year and includes equipment, machinery, vehicles and buildings, but excludes land. Property is assigned to specific classifications related to the number of years of its useful life. The property then may be depreciated over the number of years of its useful life (recovery period).

Existing state and federal law, for non-corporate taxpayers, provide that in lieu of depreciation, a taxpayer with a limited annual investment could elect to deduct up to a specified amount of the cost of qualifying property placed in service for the taxable year. For taxable years beginning during 1998, the federal deduction amount is $18,500 and the state deduction amount is $16,000.

Existing state law provides corporate taxpayers a special first-year depreciation allowance on tangible personal property having a useful life of six years or more. This deduction is in addition to the regular depreciation on the balance of the cost. The deduction is limited to 20% of the cost of the property, limited to $10,000 of property per year.

Existing state and federal laws allow a taxpayer to deduct expenses paid or incurred in the ordinary course of a taxpayer’s business.

Existing state law allows taxpayers to use various credits against tax. The MIC allows qualified taxpayers a credit equal to 6% of the amount paid or incurred after January 1, 1994, for qualified property that is placed in service in California.

For purposes of the MIC, a qualified taxpayer is any taxpayer engaged in manufacturing activities described in specified codes in the SIC Manual. Qualified property is any of the following:

1) Tangible personal property that is defined in Section 1245(a) of the Internal Revenue Code and used primarily:

- for manufacturing, processing, refining, fabricating or recycling of property;
- for research and development;
- for the maintenance, repair, measurement, or testing of otherwise qualified property; or
- for pollution control which meets or exceeds state or local standards.

2) The value of any capitalized labor costs directly allocable to the construction or modification of the property listed in #1 above or for special purpose buildings and foundations listed in #3 below.

3) Special purpose buildings and foundations that are an integral part of manufacturing, refining, processing or fabricating, or research and storage facilities that are part of the process, which are used by qualified persons performing manufacturing activities described in specific codes relating to computer, accounting, and office machines, electronic equipment and accessories, biotech or biopharmaceutical activities, semiconductor equipment manufacturing activities and certain aerospace manufacturing activities.

The MIC explicitly excludes certain types of property from the definition of qualified property, including equipment used in the extraction process, furniture, facilities used for warehousing purposes after completion of the manufacturing process, inventory, equipment used to store finished products that have completed the manufacturing process, and tangible personal property used in administration, general management, or marketing.

The MIC provides a variety of special rules for costs paid pursuant to a binding contract and leased property. The credit may be carried over until exhausted, for a maximum of eight years. For small businesses, this carryover period is extended to ten years. The taxpayer must recapture any credit previously allowed if the property is removed from California, disposed of to an unrelated party or converted to an unauthorized use within one year from the date the property is first placed in service in California.

The MIC will become inoperative on January 1, 2001, or on the January 1 of the earliest year after 2001 if the total employment in manufacturing in this state does not exceed by 100,000 jobs the total employment in manufacturing in this state on January 1, 1994. The Employment Development Department (EDD) is required to report to the Legislature annually on this determination.

Certain “new businesses” (as defined) may claim an exemption from sales and use tax instead of this tax credit. The existing sales and use tax law also allows a taxpayer to claim a refund for the sales or use tax that was paid on the purchase of qualified property rather than claiming the MIC.

This bill would include specified lines of business relating to computer programming and computer software in the definition of “qualified taxpayer” under the MIC. These activities are described in SIC Codes 7371 (Computer Programming Services), 7372 (Prepackaged Software) and 7373 (Computer Integrated Systems Design).

This bill also would include computers and computer peripheral equipment (as defined in IRC Section 168(i)(2)(B)) that is used in computer businesses described in SIC Codes 7371 to 7373 primarily for the development and manufacture of custom or prepackaged software to the definition of “qualified property” under the MIC. The value of any capitalized labor costs directly allocable to the construction or modification of such property would also be included in “qualified property.” Qualified property for taxpayers involved in computer businesses described in SIC Codes 7371 to 7373 would not include any Section

1245(a)(3)(A) property tangible personal property (e.g., shrink wrap machines, fork lifts, etc.) other than computers and computer peripheral equipment.

This bill would allow a taxpayer that is involved in a computer business described in SIC Codes 7371 to 7373 and qualifies as a small business under the MIC to claim the credit on costs expensed under Section 179 of the IRC, even though these costs would not qualify under the existing MIC provisions. However, the taxpayer would be required to reduce the amount of the Section 179 expense deduction by the amount of credit.

Policy Considerations

This bill would raise the following policy considerations.

- The SIC code references added by this bill describe some service activities. No other MIC provisions relate to providing services.
- By allowing only small businesses which are involved in computer activities to claim both the credit and the Section 179 expensing, this bill creates an inequity between small computer companies and all other businesses which cannot claim the benefits of both Section 179 and the MIC for the same property.

Implementation Considerations

Implementation of the provision of this bill would occur during the department's normal annual system update.

Technical Considerations

Amendments 1, 2 and 3 would remove redundant language (Computers and computer peripheral equipment were added twice to the definition of qualified property).

FISCAL IMPACT

Departmental Costs

This bill would not significantly impact the department's costs.

Tax Revenue Estimate

This bill is estimated to impact PIT and B&CT revenues as shown in the following table.

Fiscal Year Cash Flow Taxable or Income Years Beginning on and after January 1, 1998 Enactment Assumed After June 30, 1998 $ Millions			
Fiscal Year	1998-99	1999-00	2000-01
Applied credits	($13)	($14)	($17)

The estimated revenue losses for the June 11, 1998, amendment increased from the estimate provided for the May 5, 1997, amendment because the June 11, 1998, amendments changed the operative date and added capitalized labor costs.

This estimate does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Tax Revenue Discussion

The revenue impact for this bill would be determined by the level of qualified costs and the amount of credits applied against available tax liabilities.

This estimate was developed in the following steps. The amount of qualified costs was estimated from national data (U.S. Department of Commerce) for SIC Code 737. That amount was adjusted, using sales receipt data, to provide a proxy for the portion of overall U.S. investment that may reasonably be assumed to be accounted for by activities in SIC 7371, 7372 and 7373. The next step was to estimate the portion of national investment that would occur in California. California's share of the total was obtained by adjusting the U.S. capital expenditure figure by the ratio of California's employment over U.S. employment in SIC 7371, 7372 and 7373. The qualified expenditures for 1993 were grown to approximate levels for 1998 adjusted by capitalized labor costs. The final step was to estimate the amount of credit that would be used. This was accomplished using a microsimulation model of tax returns from prior years.

BOARD POSITION

Support.

The Franchise Tax Board voted at its April 14, 1997, meeting to support this bill as amended April 9, 1997.

Marion Mann DeJong
(916) 845-6979
Doug Bramhall

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 1063
As Amended June 11, 1998

AMENDMENT 1

On page 16, strikeout lines 5 through 12 inclusive, and insert:

(6) Qualified property does not include any of the

AMENDMENT 2

On page 29, strikeout lines 39 and 40 inclusive.

AMENDMENT 3

On page 30, strikeout lines 1 through 6 inclusive, and insert:

(6) Qualified property does not include any of the